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FEATURE: PENSIONS

PENSION PENDULUM

A few years ago, defined-contribution plans were hot. Now they're not.

By Anya Sostek

In the mid-1960s, the Nebraska legislature embarked on what would ultimately turn out to be a very expensive experiment. Nebraska had just decided to provide all state and county workers with retirement benefits, something that the state had done two decades earlier for its teachers and judges in the form of a traditional "defined-benefit" pension plan. But in the spirit of the '60s, the state decided to blaze new ground, selecting an up-and-coming idea called "defined contribution" for the state and county workers.

Where defined-benefit plans gave employees a fixed amount of money at retirement, usually based on their salary and years of service, the new defined-contribution plans created individual employee savings accounts, allowing workers to invest the money on their own. As the 20th century drew to a close, Nebraska's decision seemed positively prescient. Many other state governments were considering legislation to adopt similar plans, which had already caught fire in the private sector in the form of 401(k) accounts.

But Nebraskans' feelings about such plans changed in the year 2000, after a large-scale study of the state pension system. The results shocked even those who already had doubts about the defined-contribution approach. During the period from 1983 to 1999, state and county workers averaged a 6 percent return on their money--versus an 11 percent return for the state's professional investors handling the traditional pension money.

Faced with such a disparity, legislators acted almost immediately to change the system, ending the defined-contribution plan for new hires and giving all other workers the option to switch into a hybrid plan. "We had to take a look in the mirror and think, is this really providing a true pension?" says Anna Sullivan, executive director of Nebraska Public Employee Retirement Systems. "It's really sad what they retire with. It's nothing compared to what people in our defined-benefit plan receive."

Nebraska's experience is unlike that of any other state--in the duration of the plan, the level of data collected and the abrupt shift away from defined contribution. But Nebraska's experience was a harbinger for a nationwide trend. Momentum for defined-contribution plans, which peaked nationwide with the red-hot stock market of the late 1990s, has slowed significantly in the wake of the market downturn. Since then, no states have adopted new plans and participation in optional plans is far below projected levels. "I don't think Nebraska is unique," says Sullivan, who has worked for the state pension system for 28 years. "I read every article I can get my hands on, and the patterns are very similar."

FLEXIBILITY VS. RISK

Virtually all governments started out offering their workers defined-benefit plans: As long as employees worked the number of years required to be vested in the system, they were guaranteed a fixed, annual amount based on their salaries and years of service. In the 1980s, the private-sector shift to defined-contribution plans took off as small employers realized they offered a way to provide retirement benefits with essentially no financial risk. Younger workers, who tend to change jobs frequently, appreciate the portability. When they leave a job, they can take the contributed funds with them.

Of the nearly two-thirds of private-sector workers who had pension plans in 2000, 22 percent were in defined-benefit programs; 42 percent were in defined-contribution plans. In contrast, 90 percent of government workers are in defined-benefit, with only 10 percent in defined-contribution programs. It is increasingly common, however, for governments to offer supplemental defined-contribution plans, in addition to their defined-benefit plan.

The most important difference between the two plans boils down to who is left holding the bag if investments turn sour. In a defined-benefit plan, the risk lies with the employer. If an employer--private or public--is lax in its funding, or if it invests its money poorly, it is still on the hook to pay employees their guaranteed benefits. With governments under constant fiscal pressures, underfunding of pension plans is not uncommon. In one of the worst such cases in the early 1990s, the West Virginia teachers' pension fund had a total liability of $3.2 billion and had assets of less than $300 million. The few places that are still considering defined-contribution plans--notably New York and Massachusetts--are doing so mainly because of concerns about their ability to fund a traditional plan.

Defined-contribution plans have no possibility of incurring a funding deficit, because each employee has his or her own money already saved in an account. "Defined-contribution plans mean that there's no future liability that has to be paid for," says Trevor Martin, director of the commerce and economic development task force for the American Legislative Exchange Council. With the defined-benefit plan, on the other hand, if pension funds "default or underperform severely, it all boils down to costing taxpayers," Martin says.

To force itself to straighten out its finances, West Virginia switched to a defined-contribution plan in 1993. The funding is now stable, but teachers are asking to switch back to a defined-benefit plan--a proposal that the legislature is considering this session.

It turns out that, as Nebraska learned, employees are not comfortable investing their own money. "It's like sitting in a car and you've never seen a steering wheel before, and they say to drive this thing," says David Haney, executive director of the West Virginia Education Association. "You may figure it out eventually, but it may wreck in the process." Haney contends that an aggressive education program is a necessary component of a defined-contribution plan, and that West Virginia teachers weren't given any semblance of an education.

Even in Nebraska, where employees were given the option of taking off work to attend full-day financial seminars, investment performance was woeful. "I don't think that people have the discipline, the time or the temperament to manage their own defined-contribution account and to have that be their whole retirement," says Sullivan.

TEPID INTEREST

The flip side of the risk in defined-contribution plans comes when an employee invests well and ends up flush in retirement money. If investments don't pan out as expected, however, it's the individual employee's retirement savings on the line. For that reason, employee enthusiasm for defined-contribution plans often mirrors the Dow Jones index. "When the market is doing well, people are very excited about defined contribution," says ALEC's Martin. "When the market is doing poorly, people get excited about defined benefit."

Florida learned that lesson the hard way. The state enacted a law in 2000 creating a defined-contribution plan and also making reforms to its defined-benefit plan, such as a shorter vesting period. The measure, passed at the height of the stock market boom, was designed mainly to compete for younger workers tempted by the private sector. It was estimated at the time that 30 percent of the state's 600,000 eligible public employees would switch into the defined-contribution plan.

Two years later, when it came time for people to make a decision, the market was severely battered. Furthermore, the nation had grown very familiar with the fate of some Enron workers and the complete evaporation of their retirement savings. Even though government defined-contribution plans don't allow risky investments in a single company, employees were skittish about the market and frightened about their retirement savings. Thus far, only 3 percent of Florida employees have actually exercised their option to switch plans--far below the 30 percent projection.

Other states that recently established optional defined-contribution plans saw similar results. In Ohio, a defined-contribution plan and a hybrid plan for teachers have attracted only 2.5 percent of existing employees and 25 percent of new hires. Even though the market was still soaring when Michigan introduced its defined-contribution plan in 1997, only 6 percent of employees decided to join.

The issue of risk also recently propelled the city of Alexandria, Virginia, to begin the process of switching from a defined-contribution plan to a defined-benefit plan for its police and firefighters. "With the changes in the stock market, we started asking ourselves, why do the employees have the investment risk," says finance director Daniel Neckel. "Why doesn't the city have the investment risk?"

HYBRIDS TO THE RESCUE?

Even though the stock market rebound is boosting investment returns, state and local governments still face intense budget pressures, and some are looking to hybrid plans for relief. On the brink of fiscal disaster, the state of Oregon was forced to completely overhaul its unusually generous pension system. Among the reforms, the state legislature agreed on a mandatory hybrid plan for new and existing employees.

Under the plan, which went into effect this year, employer contributions go into a defined-benefit fund, with a guaranteed retirement benefit. Employee contributions go into a defined-contribution fund, which employees can invest as they please and take with them if they leave the job. In some ways, the plan provides the best of both worlds. "That could be the trend," says Randy Taylor, senior vice president of CitiStreet, a private company that administers government defined-contribution plans. "A hybrid program giving members defined benefits but also allowing some self-direction."

Nebraska's solution is also a hybrid, called a cash balance plan. Workers were given the option to keep whatever money was in their defined-contribution accounts, and to transfer it into the new cash balance account. All employees in the new plan still get a quarterly statement with their account balance, and can take whatever is in their account with them if they leave. But they no longer have control over the investments in the account. The money is now pooled and invested by the state, with a guaranteed return.

For Sullivan, the new plan provides an acceptable compromise. She is still frustrated by employees who cash out their savings for a big purchase when they leave government. But she is much more at ease with the investment activity. "I think that in a defined-benefit plan, your dollars work harder for you," she says. "For the same amount of money, you can provide a better benefit."

NEST EGG NUMBERS

State and local government employee retirement system finances, FY 2002

Total contributions: $66 billion*
 --Employee contributions: 41.5%
 --Local government contributions: 32.6%
 --State government contributions: 25.9%

* Total receipts for the year were -$6 billion, as earnings on investment totaled -$72 billion

Total payments: $122 billion
 --Benefits: 90.0%
 --Other payments: 6.4%
 --Withdrawals: 3.3%

Source: U.S. Census Bureau
